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VIA FEDERAL EXPRESS AND
VIA ELECTRONIC MAIL TO:
coastalrm@calepa.ca.gov

Mr. Leonard Robinson
Acting Director
California Department of Toxic Substances Control
1001 "I" Street
Sacramento, CA 95812-0806

Re: **November 29, 2005 Workshop on Financial Assurance – Comments on Financial Test and Captive Insurance Issues**

Dear Mr. Robinson:

On behalf of the RCRA Corrective Action Project and the Superfund Settlements Project (hereinafter collectively "the Projects"), this letter provides substantive comments in advance of DTCS's upcoming November 29, 2005 financial assurance workshop focused on financial test issues and captive insurance issues. We very much appreciate the opportunity to comment on these important issues as presented in the DTSC's various discussion papers.

As set forth below in greater detail, we believe that the DTSC discussion papers overall present an unduly negative view of the existing financial assurance framework for environmental cleanups. This letter presents the response of the Projects to some of the major points made in the discussion papers. We hope that this response will stimulate further analysis and debate about these very important issues.

I. Background on RCAP and SSP

The Superfund Settlements Project ("SSP") and the RCRA Corrective Action Project ("RCAP") have worked since their formation nearly 20 years ago to provide constructive input to EPA and other federal and state agencies on critical policy issues affecting the cleanup of contaminated sites. The members of these two Projects include companies that maintain their corporate headquarters in California, companies that have substantial operations in California, and companies that are responsible for addressing contaminated sites in California.

Moreover, each of the Projects' member companies has extensive experience with contaminated sites. As just one indicator of the scope of that experience, the members of the SSP alone have spent over $6 billion in the investigation and remediation of contaminated sites, including many sites in California, since the major federal and state cleanup programs began some 25 years ago.

On behalf of their members, the Projects are pleased to submit these joint comments on the DTSC's discussion papers regarding two aspects of financial assurance: (1) the financial test and (2) the use of captive insurance.

II. Issues Associated with the Financial Test.

The Projects recognize that financial assurance is an essential element of the legal framework for cleanup of contaminated sites. We fully support sound and reasonable requirements to provide such assurance.

Despite our strong support for financial assurance, we are deeply concerned that the DTSC discussion paper on the financial test is flawed in two respects: It overstates the perceived problems with the test, and it suggests a variety of regulatory changes that are unnecessary and would not improve the program.

A. The Current Framework Has Worked Well.

The discussion paper candidly acknowledges that "there have been no instances where DTSC had to perform closure, postclosure, or corrective action activities where a facility owner/operator using the financial test has failed" (emphasis supplied). In fact, DTSC's experience in this regard mirrors what has occurred throughout the United States.

Thousands of sites undergoing either Superfund cleanup or RCRA corrective action have been addressed, in whole or in part. Yet we know of no reported instances where one of these sites became a taxpayer liability because an owner/operator or a potentially responsible party ("PRP") defaulted on its financial assurance mechanism.[1]

This highly successful track record to date is, of course, no guarantee against future defaults. But it is highly relevant to any analysis of whether the existing

[1] In fact, something quite different occurred at the BKK Landfill site in California. When the owner/operator declared that it was unable to continue funding cleanup efforts, various PRPs at the site took over the project.

framework for financial assurance is working well, and whether any changes should be made to that framework.[2]

B. Background on the Financial Assurance Regulations

At the outset, it is important to understand what "financial assurance" is meant to accomplish and how it works in practice. The regulatory framework was promulgated by EPA in 1982. Those regulations addressed financial assurance for permitted RCRA treatment, storage, and disposal facilities ("TDSFs"), but they have since been used by EPA and most states for Superfund sites and RCRA corrective action sites as well.[3] Under those rules, the owner/operators or PRPs who are responsible for closure, post-closure care, corrective action, or remediation (hereinafter generally "cleanup") must establish and maintain financial assurance for that work.

Significantly, financial assurance is <u>not</u> meant to be the primary means by which a company fulfills its cleanup obligations. Instead, financial assurance is meant to be the <u>back-up</u> mechanism in the unlikely event that the company is otherwise unable to fulfill those obligations.

The EPA rules, which today are part of the authorized RCRA Subtitle C program in virtually all States, require owner/operators and PRPs to demonstrate financial assurance using one or more of six main options:

- a trust fund;
- a surety bond;
- a letter of credit;
- an insurance policy;
- a financial test; or
- a corporate guarantee.

The detailed requirements for these six mechanisms fill some 55 pages in the Code of Federal Regulations at 40 C.F.R. Part 264, Subpart H.[4]

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[2] The discussion paper's references to the Enron and WorldCom accounting scandals, which did not involve any environmental liabilities, are distracting and unhelpful. No legal mechanism can prevent the commission of fraud by someone determined to engage in fraudulent conduct. The fact that some companies manage to defraud their creditors is hardly an indictment of the current framework governing financial responsibility for environmental cleanup liabilities.

[3] The RCRA rules are legally applicable only to TSDFs. EPA has decided, as a matter of policy, to require the same financial assurance mechanisms at RCRA facilities undergoing corrective action and at Superfund sites as well, using judicial consent decrees, unilateral administrative orders, and administrative orders on consent to incorporate the RCRA rules for TSDFs.

[4] Although the financial assurance rules are lengthy and detailed, they are not nearly as complex as many other EPA RCRA rules, such as the definition of "solid waste."

For financially strong companies, EPA's regulations provide low-cost mechanisms such as the financial test, which relies upon the inherent strength of the company to assure performance of its obligations. For less-strong companies that could not qualify for the financial test, EPA's rules provide costlier mechanisms, such as letters of credit and surety bonds, to minimize the possibility that the liabilities of these companies would be shifted to the taxpayers. In other words, EPA recognized that <u>different financial assurance mechanisms are appropriate for different companies,</u> depending upon their size and strength, among other factors.

The financial test mechanism was adopted by EPA only after a careful analysis of competing considerations and supporting evidence. For example, EPA decided to use fairly simple measures to evaluate financial performance for the purpose of determining whether a company would be able to cover its cleanup obligations. These include readily available measures such as a company's bond rating, its tangible net worth, and its net working capital.

The EPA financial test is also quite conservative. It requires <u>either:</u>

- a bond rating of a certain grade[5] plus tangible net worth of at least $10 million plus <u>net tangible worth of 6 times total remediation liabilities</u> ("Alternative II"), <u>or</u>

- two of three other factors <u>plus</u> tangible net worth of at least $10 million <u>plus</u> <u>net working capital (i.e., liquid assets) of 6 times total remediation liabilities</u> ("Alternative I").

Putting aside for a moment the other factors included in Alternative I, these are very conservative measures for evaluating whether a company can pay its debts as they come due. We discuss some of these measures below in greater detail.

In particular, Alternative II's reliance on bond ratings should give environmental regulators a high degree of confidence that business failures are unlikely for at least the next several years. The major bond rating agencies monitor both the market conditions and the individual circumstances of the companies they rate on a continuous basis. They normally update their ratings each year, but any time there is a significant change, either in the market or in the company itself, they tend to perform a more thorough review and then update their rating as warranted.

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[5] The bond rating of the owner/operator reflect the expert opinion of bond rating services and evaluates the firm's financial management practices. The rating firms, S&P and Moody's, are well respected and widely utilized sources for credit ratings.

C. Concerns About the Financial Test are Overstated.

The discussion paper gets off on the wrong foot by suggesting that the financial test "provides absolutely no certainty as to the amount or the availability of funds." Although "certainty" is an elusive goal in most human endeavors, the financial test actually provides a robust assessment of the current financial strength of a company and also of the likelihood that it may undergo financial deterioration in the next several years.

In that regard, the financial test was specifically designed to cover a 3-year "look-ahead" period. EPA determined that companies qualifying for the financial test are highly unlikely to seek bankruptcy protection or otherwise default over the next 3 years. This 3-year "look-ahead" aspect is a central feature of the financial test, but it has often been overlooked in the policy debate on financial assurance. Because a company must re-qualify again every year if it wishes to keep using the financial test, there is always at least a 2-year "look-ahead" period during which a default is highly unlikely. In fact, EPA has reviewed this issue several times (e.g., in connection with financial assurance for municipal solid waste landfills), and has reaffirmed its original analysis.

D. The Suggested Changes to the Financial Test Are Not Justified.

The discussion paper suggests four possible changes to the financial test. We address each of these separately. In Section II-F below, we also address some of the costs and burdens that would be associated with rulemaking aimed at implementing these changes.

1. The $10 Million Tangible Net Worth Requirement Should be Preserved.

In its 1982 RCRA rulemaking, EPA concluded that a company meeting the required threshold of $10 million in tangible net worth was extremely unlikely to declare bankruptcy at any time in the next 3 years. In other words, the financial test is constructed to screen out companies that have a significant risk of declaring bankruptcy at any time in the next 3 years.

The discussion paper says that "not adjusting the $10 million tangible net worth requirement to reflect inflation has substantially increased the risk of bankruptcy." No support for this statement is offered, perhaps because the statement was thought to be simple common sense, but in fact it is incorrect.

EPA's original analysis has actually been revisited on several occasions – most notably in the late 1990s, in connection with the development of financial assurance rules for municipal solid waste landfills – and its validity has been reaffirmed each time. *See, e.g.*, 63 Fed. Reg. 17,706, 17,715-18 (April 10, 1998) (discussing comments and explaining retention of $10 million standard in final rule on financial assurance for municipal solid waste landfills); 50 Fed. Reg.

30,201 (July 1, 1991) (proposing certain revisions to Alternative I, but not proposing to modify the $10 million standard). EPA is well aware of the fact of inflation. Given EPA's recent review and retention of the $10 million tangible net worth requirement, substantial further analysis is required to support any upward adjustment in this standard.

2. Assets Used as Security Should Not Be Excluded from the Computation of Tangible Net Worth for Companies with Bond Ratings.

The discussion paper suggests that assets pledged as security for indebtedness should not count toward the tangible net worth requirements in the financial test. We have significant reservations about this approach.

Companies that qualify for Alternative II based on their published bond ratings should not have to adjust their tangible net worth in this manner. The bond ratings already take into account all of their assets and liabilities, including both the net value of pledged assets and also the debt secured by those assets. For companies with sufficiently strong bond ratings to use Alternative II, there is little point to fine-tuning the computation of tangible net worth in this fashion.

3. The Altman's Z Score Option Should Not Be Required.

For the reasons presented by the American Chemistry Council in its separate comment letter to DTSC dated November 14, 2005, we believe that this suggested change is unsupported and unwise. In particular, companies with published bond ratings that qualify for Alternative II of the financial test should not be subject to duplicative evaluations of their credit-worthiness.

4. Any Change to Line 1 of the DTSC Financial Test Form Should be Carefully Reviewed.

Companies using the financial test are typically required to disclose their other environmental liabilities, including the specific cost estimates for each of the other sites involved, regardless of which state(s) those facilities are located in. The discussion paper suggests that, in addition, companies should report the regulatory cost amounts and third-party liability amounts for out-of-state facilities "to the extent the owner/operator is using the financial test to guarantee those obligations." In other words, a company using the financial test for its closure obligations at facilities in both California and Texas would be required to report the total amount of those obligations on Line 1 of DTSC's financial test form. We do not object to this change, so long as it is limited to those out-of-state obligations for which the company is using the financial test.

E. The "Negative Assurance" Issue Does Not Mandate Rulemaking to Change the Financial Test.

The workshop materials also suggest that changes to the financial test are needed because of the negative assurance/agreed-upon procedure issue. Specifically, the DTSC issues paper states that "the Department is prohibited by law from accepting the agreed upon procedures in lieu of the negative assurance." We believe that this is incorrect.

The current regulatory situation is admittedly somewhat unusual. EPA's 1982 RCRA financial assurance rules require each company relying upon the financial test to submit a special report from its independent certified public accountant. That special report must include a statement that he has compared the company's audited financial statements with the letter from the company's chief financial officer summarizing certain data from those statements and that "no matters came to his attention which caused him to believe that the specified data should be adjusted." 40 C.F.R. § 264.143(f)(3)(iii)(b) (2005).

This statement that "no matters came to his attention" is commonly referred to as the "negative assurance" by the accountant. The wording of the DTSC regulation is virtually identical, 22 Cal. Reg. § 66264.143(f)(3)(C), and most other states have adopted this language as well, either through incorporation by reference or otherwise.

In 1995, the Auditing Standards Board of the FASB issued new standards that effectively prevented accountants from giving negative assurances in cases where the client and the independent accountant enter into an agreement that defines the scope of the accountant's work. This created some regulatory tension, because companies using the financial test were supposed to provide "negative assurances" from their accountants, but the accountants were no longer able to render those "negative assurances."

Eighteen months later, EPA issued a memorandum designed to address this problem. In this 1997 memorandum, EPA stated that it intended to address the situation through rulemaking and, in the meantime:

> "EPA will accept a CPA's report describing the procedures performed and related findings, including whether or not there were discrepancies found in the comparison, based on an agreed-procedures engagement performed in accordance with [the new standards]. . . . The Agency will regard this report as satisfying the requirements of the financial test . . . for a special report by an independent CPA . . . ."

Although the resulting situation is not ideal, it provides the regulated community with practical guidance on how to maintain their compliance pending further action by EPA to address the issue. DTSC has suggested that it lacks discretion to take an approach similar to EPA's, and that it must engage in rulemaking to modify the financial test. We believe this suggestion is unfounded.

This entire issue arises from the RCRA Subtitle C financial assurance regulations that were issued by EPA and then adopted by virtually all States in order to obtain program authorization under section 3006 of RCRA. The DTSC rules are thus closely patterned on the EPA template rules. With regard to the "negative assurance" issue, the two sets of rules are virtually identical.

DTSC states that "[t]he Department does not have the discretion to accept an agreed upon procedures statement [because it is] less stringent that the express requirements of State and federal regulations." We agree that as a condition of program authorization, DTSC's RCRA program must be at least as stringent as the federal program. But there is no issue here of stringency. With regard to the negative assurance issue, DTSC's published regulations are every bit as stringent as the federal regulations. So DTSC has satisfied the requirements of RCRA § 3006.

The real issue here is one of enforcement discretion. EPA has clearly stated that in view of the current disconnect between the RCRA rules and practices of the accounting profession, it will accept an agreed upon procedures statement as satisfying the negative assurance requirement for the independent accountant's report. We know of no impediment to DTSC adopting this same approach. In fact, DTSC's enforcement discretion allows it to do precisely what EPA has, done pending a more satisfying long-term resolution of this issue.

In sum, the "negative assurance" issue does not compel any rulemaking by DTSC to revise its financial test regulations.

F. More Stringent Financial Assurance Would Come at a Cost.

The discussion paper reveals a policy preference for requiring more liquid forms of financial assurance for virtually all cleanup obligations. Unfortunately, the discussion paper looks only at the asserted benefits of more financial assurance, and does not take into account the costs. As we show below, those costs are substantial. They include not only the out-of-pocket cost of acquiring more financial assurance, but also the uncertainty and delay that would attend any effort to rewrite RCRA rules that have been on the books for more than two decades.

To begin with, if the financial test were eliminated, as the discussion paper suggests it could be, then the actual out-of-pocket cost of liquid financial assurance mechanisms could exceed $1 billion per year on a nationwide basis. The universe of sites to be addressed nationwide includes at least 5,000 sites (Superfund NPL sites plus RCRA TSDFs plus RCRA corrective action sites that are not TSDFs). Using an average cleanup cost figure of $10 million, which is probably on the low side, the total cost of the work to be performed may be in the range of $50 billion. Not all of that work will be performed in California, but a very significant fraction of it will be.

The estimated annual cost of a letter of credit, often considered the least costly financial instrument, is approximately 3% of the amount being guaranteed. Thus, if letters of credit were to be required, then the total amount of money that would be paid to the issuing banks and other institutions in any given year would be roughly $1.5 billion on a nationwide basis.[6] Before any costs of this magnitude are imposed, it would be essential to analyze both their benefits and their costs.

Moreover, every dollar spent on financial instruments is a dollar that is not available for capital improvements such as new plants, proactive investment in pollution control equipment, and the like. This is not only a matter of decreased return to shareholders on their investment; it also affects the amount of money available to run the business.

Apart from these out-of-pocket costs, there is also the uncertainty and confusion that would result from changes to the existing framework for financial assurance. EPA's existing financial assurance requirements were adopted through notice-and-comment rulemaking in 1982. Since that time, the very detailed provisions of these regulations have been built into the authorized RCRA programs of 48 States.[7] These provisions have also been built into numerous RCRA and HSWA permits, as well as into many RCRA and CERCLA consent decrees and other enforceable agreements.

Any revisions to the baseline financial assurance regulations would also entail a protracted process that will generate greater confusion and uncertainty. Experience teaches that the RCRA rulemaking process (and any judicial review) will take a number of years to complete.

In sum, the process of revising the financial assurance rules would bring with it substantial costs, as well as delay and uncertainty. This is not a process to be undertaken unless there is strong reason to believe that a significant problem needs to be corrected. For the reasons previously stated, we believe that no such problem exists.

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[6] The actual amount might be less if the PRPs were permitted (as they are under current RCRA rules) to reduce the amount of the letter of credit each year as the cost of the remaining cleanup work decreased.

[7] In many States, the EPA requirements were incorporated by reference. In other States, they were specifically enacted by the legislature.

III. Issues Associated with Captive Insurance

Turning now to captive insurance, the DTSC discussion paper states that "captive insurance does not provide the same safeguards as the financial test" because "[t]here is no annual review of the financial health of . . . the captive . . . ." This statement proves too much, because it is true of all liability insurance, not just captive insurance. In other words, the facility obtains an insurance policy and the environmental regulatory agency does not conduct an annual review of the financial health of the insurance carrier. Yet EPA, DTSC, and virtually all state environmental regulators recognize that liability insurance is an important option for many facilities seeking to demonstrate financial responsibility for various cleanup obligations. Therefore, it is essential to focus on whether captive insurance is, in fact, so different from other types of insurance that its regulatory status should be different. We believe the answer is "no."

At the outset, it is important to understand what captive insurance is and how it works. In essence, a subsidiary corporation is established to write insurance for its parent entity.[8] This arrangement allows the parent to avoid the uncertainties and cost fluctuations of the commercial insurance market by having its insurance needs met by an entity subject to its control.

> "Such captives are usually set up for one of three reasons: one, the risk is otherwise uninsurable, in which event there is a sound business purpose behind such procedure; second, the parent seeks to save money on premiums, in which event, assuming its judgment is sound, more profit remains in the parent which will be taxed; third, the parent company may not qualify [to write insurance] under the laws of that state, requiring a subsidiary company to be established for that purpose."

Appleman on Insurance Law & Practice § 10999 (Matthew Bender 2005).

Captive insurance is a sophisticated and legitimate financial strategy that benefits the large and medium-sized insurance consumer by providing it with greater control over its risk programs, the ability to achieve cost savings and efficiencies that are passed on throughout its organization, and the opportunity to customize the type(s) of insurance coverage that it purchases. The captive insurer, in turn, is free to tap the reinsurance market directly in order to spread its potential liabilities more broadly.

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[8] "Captive insurance companies are typically closely-held companies whose insurance business is supplied and controlled by the owners, in which the original insureds are the principal beneficiaries." Business Insurance Law & Practice Guide § 26.03[1] (Matthew Bender 2005). A captive insurance company is commonly formed as a sister company to the insured, e.g., as a subsidiary of the parent holding company that owns the insured.

Captive insurance has grown dramatically in recent years. Roughly half of the 50 States have statutes specifically allowing captive insurers to be chartered as insurance companies.[9] "The six leading domiciliary states actively market their competitive advantages on Web sites, at trade conferences, and through relationships established with trade groups. . . . Vermont emphasizes that it is the third-largest captive insurance domicile in the world and the number one in the United States, with an insurance department that has more than 20 years of experience in regulation [risk retention groups.]"[10]

We turn now to the 4 questions that DTSC raised in its workshop materials.

1. Does captive insurance provide the same level of assurance as third-party insurance?

The level of assurance provided by <u>any</u> insurance contract depends upon the financial strength of the issuer, be it a captive insurer or a third-party carrier. So long as the insurer has sufficient resources to meet its expected payments, the level of assurance provided is also sufficient.

The discussion paper suggests that "captive insurance lacks the essential characteristics of true insurance [i.e.,] risk-shifting and risk-distribution." As support for this proposition, DTSC quotes dictum from *Amerco, Inc. v. Commissioner of Internal Revenue*, 979 F.2d 162 (9^{th} Cir. 1992), a tax case involving insurance contracts between sister corporations. In fact, the *Amerco* court ruled that such contracts <u>did</u> involve both risk-shifting and risk-distribution, and thus constituted true insurance. *Accord, Humana Inc. v. Commissioner of Internal Revenue,* 881 F.2d 247 (6th Cir. 1989).

It is noteworthy that the cases analyzing whether captive insurance qualifies as "insurance" are tax cases, where all that is really at stake there is the deductibility of the premiums paid by the parent corporation. Where the tax cases find that captive insurance is not "insurance," they do so because the parent's balance sheet will ultimately reflect any decrease in value suffered by the captive insurer when it pays the liability or loss of the parent. Appleman on Insurance Law & Practice § 10999 (Matthew Bender 2005).

This may make sense as an accounting matter, but it has no bearing on whether captive insurance provides "insurance" for purposes of demonstrating financial assurance. Thus, the discussion paper is wrong when it says that "the financial stability of the [captive insurer] is completely dependent on the financial health of the parent." Every captive insurer is a separate corporation, and must be adequately capitalized to meet its anticipated obligations. Moreover, captive insurers can be rated for financial strength by AM Best, S & P, and Fitch rating

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[9] U.S. Government Accountability Office, *Risk Retention Groups* 29-30 (2005) (GAO-05-536).

[10] Id. at 44.

services. Such ratings involve annual reviews of the captive's operations, reviews of their audited financial statements, and reviews of their reinsurance programs. So the financial stability of the captive is separate and distinct from that of the parent, and can be assessed and rated on a separate basis.

Similarly, the discussion paper is wrong when it says that "a failure of the parent . . . will necessarily cause a failure of the captive insurer." For one thing, the captive insurer may have spread its liability risks through the reinsurance market, giving it access to added coverage. More fundamentally, a reversal in the fortunes of the parent does not "necessarily cause a failure of" the subsidiary. If the subsidiary was undercapitalized, then it would not be recognized as a separate legal entity in the first place.

2. Should the use of captive insurance be allowed?

We know of no factual basis for treating captive insurance differently than third-party insurance. Specifically, we know of no instance in which a captive insurer has failed, resulting in a default on environmental cleanup obligations of the parent.

3. What assurance is provided by the licensing process for captive insurers in Vermont and other states? Would additional benefit be provided by requiring captive insurers to be licensed in California?

In response to the first question, Vermont's regulatory framework for captive insurance companies should serve as a model for strict standards. The licensing requirements are rigorous. Once a captive insurer is approved, Vermont maintains close oversight of all company operations and requires pre-approval of any change in the plan of operations.

Under the Vermont program, other key requirements include:

- audited financial statements;
- actuarial certification of loss reserves, calculated by an approved actuarial firm;
- a statutory annual report including financial and insurance operational information;
- parent company financial statements; and
- biographical affidavits outlining the background of every officer, director and key employee.

In response to the second question, we believe there is no basis to require captive insurers to be licensed in California simply because they provide coverage for one or more facilities located in California. The reason is grounded in our federal system of government.

Specifically, insurance is regulated at the State level, but each State typically accepts the insurance contracts of companies that are licensed to write insurance in other States. Any other approach would be chaotic and would ultimately impose a huge burden on interstate commerce. For example, many property and casualty companies are chartered in Connecticut, and yet their insurance contracts are accepted everywhere in the United States. The reason for this is not that the judgment of the insurance regulators in Connecticut is infallible. Rather, the reason is that it is unworkable for each State to review and supervise economic activity that is primarily under the jurisdiction of another State. If each State decided to require that TSDFs obtain insurance from carriers (captive or otherwise) licensed in that particular State, the result would be complete chaos in the insurance markets. Such protectionism would be both unlawful (as an undue burden on interstate commerce) and also unwise.

4. Should the use of captive insurance be limited to certain types of assurance? For example, liability only.

We see no principled basis for limiting the use of captive insurance to certain types of financial assurance.

IV. Conclusion

The Projects believe that the current financial assurance regime has worked well for the past 25 years. Thousands of sites have been cleaned up, in whole or in part, with most of the work performed and funded by owner/operators and PRPs. All of this work occurred under the existing financial assurance mechanisms. Moreover, we know of no site that "defaulted" to the taxpayers due to a failure of those mechanisms. This track record demonstrates that things are working well.

It is always possible that new problems will emerge in the future that require modification of the existing framework. But with so much at stake for all concerned, we see little need to make major changes simply because something might go wrong tomorrow.

Thank you in advance for your consideration of our views.

Very truly yours,

John Quarles

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